TABLE OF CONTENTS

TABLE OF CONTENTS—Contnued

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-1490

FEDERAL POWER COMMISSION

v.

TEXACO, INC., ET AL.

No. 72-1491

DUDLEY T. DOUGHERTY, ET AL., CO-EXECUTORS OF THE ESTATE OF MRS. JAMES R. DOUGHERTY, ET AL.

v.

TEXACO, INC., ET AL.

On Petitions for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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BRIEF FOR THE PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK, RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-22a)[1] is reported at 474 F.2d 416. The initial order (No. 428) of the Federal Power Commission (App. 135-154), its order (No. 428-A) of amendment (App. 159-161), and its order (No. 428-B) denying rehearing (App. 238-253) are reported at 45 F.P.C. 454, 45 F.P.C. 548, and 46 F.P.C. 47, respectively.

JURISDICTION

The judgment of the court of appeals (Pet. App. 23a-25a) was entered on December 12, 1972, and the Commission's petition for rehearing was denied on February 5, 1973 (Pet. App. 26a-28a). The petitions for writs of certiorari were filed on May 3, 1973, and granted on October 9, 1973 (App. 254). The jurisdiction of this Court rests on 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission acted properly under the Natural Gas Act in freeing all new sales of small producers from any rate regulation as long as their rates are consistent with the highest *contract* rates of large producers or the prevailing rate for gas in the unregulated *intrastate* market?

2. Whether the Commission may regulate the rates for new sales by small producers indirectly through rate proceedings involving the pipeline and large producer purchasers of their gas, while freeing the small producers

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[1] Citations in this brief to "Pet. App." refer to the Appendix to the Petition for Writ of Certiorari in Case No. 72-1490, and citations to "App." refer to the printed brown Appendix in the consolidated proceeding.

rom all refund or rate reduction obligations as a result f such proceedings.

3. Whether there is any justification for the absolute leregulation of all existing sales of gas by small proucers.

STATUTES INVOLVED

The relevant portions of the *Natural Gas Act*, 15 U.S.C. 717 *et seq.* are set forth in the Appendix to the brief filed by the Federal Power Commission in No. 72-1490.

STATEMENT

This case is before the Court to review a decision of the Court of Appeals for the District of Columbia Circuit (Pet. App. 1a-22a) setting aside orders of the Federal Power Commission which freed sales by "small producers" in interstate commerce for resale from any rate regulation under the Natural Gas Act, but purported to control the rate level of new sales by small producers when the pipeline or large producer purchasers of the gas seek to pass the increased costs on to their customers. The Court of Appeals held that the Commission's plan for the indirect regulation of the small producers rates was based upon unregulated market standards having no relation to the just and reasonable test imposed by the Natural Gas Act and was thus unlawful.

The Public Service Commission of the State of New York (New York) is a regulatory agency established under the laws of that state to protect the interest of New York's citizens in the furnishing of adequate utility service, including natural gas, at reasonable rates. In this capacity it participated fully in the proceeding below before the Federal Power Commission, and was one of the petitioners in the court below.

The Nature of the Problem

Ever since it was definitely established in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954) that sales of gas in interstate commerce for resale by independent producers were subject to the rate and certificate provisions of the Natural Gas Act, questions have been raised as to the appropriate procedures for regulating the numerous small producers who make up the great bulk of the entities involved in the production and sale of natural gas but account for a relatively small portion of the total volumes of gas, or purchased gas costs of the interstate pipelines. The Natural Gas Act, in unambiguous terms, states that its rate making standards and provisions apply to "all rates and charges" by "any natural gas company" with respect to jurisdictional sales, and that "any such rate or charge that is not just and reasonable is hereby declared to be unlawful" (see Section 4(a)). Similarly, the certificate provisions of Section 7 preclude any jurisdictional sales unless a certificate of public convenience or necessity has been issued therefor. And the only provision in the Act made for relief from these requirements is the proviso to Section 7(c) which authorizes the Commission by regulation to exempt from the Act's certification requirements "temporary acts or operations for which the issuance of a certificate will not be required in the public interest." Since there were and are more than three thousand separate entities engaged in natural gas production and sale for resale in interstate commerce, the problem of how the Commission could manage its responsibilities, and equally important how the administrative expense of regulation pursuant to the statutory standards could avoid imposing a crushing economic burden on the smaller producers, loomed large among the many difficult problems faced by the Commission in formulating effective regulatory procedures for producer regulation.

The problem was peculiarly acute during the eight year period subsequent to *Phillips* when the Commission operated on the assumption that the proper manner of regulating producers was on the individual company basis it had applied in the case of pipelines and electric utilities. Since the first major producer case was not ready for decision until late 1961, the specter of an interminable number of separate but complex proceedings haunted the regulatory effort, with the Commission estimating it would take it well into the twenty first century to dispose of its existing backlog of individual company rate cases. The avoidance of this administrative morass was one of the principal factors that led the Commission in the second *Phillips case*, 24 F.P.C. 537 (1960) to move to area rates as the solution for its producer rate problems.

The Commission's determination to abandon individual producer rule cases and move to area rate proceedings was affirmed in *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294 (1963). In his dissenting opinion there, (373 U.S. at 329-330) Mr. Justice Clark first raised the question of a possible "temporary" exemption of small producers while the Commission concentrated on the rates of the largest individual producers. This, he suggested, might be a more effective approach to the administrative problem than the area rate technique he was convinced would, for other reasons, not provide adequate consumer protection. Subsequently, in *F.P.C.* v. *Hunt*, 376 U.S. 515, 527 (1964), Justice Clark, here speaking for a majority of the Court in a certificate case, suggested that the administrative delay resulting from dealing with all producer sales certificate applications on an individual basis, which, it was alleged "transposes, for all practical matters, temporary certificates into permanent ones," might be avoided if the Commission found itself in a position to utilize exemption practices similar to those then followed by the National Labor Relations Board.

In the *Permian Basin Area Rate Case*, 34 F.P.C. 159 (1965), the first of the area proceedings, the Commission came to grips with the problem of the small producers. It did so on the basis of a record which was most ambiguous as to the extent to which, if any, the unit costs of such small producers were higher than those of the producers as a whole.[2] The Commission concluded, however, (34 F.P.C. at 234-35) that special treatment for small producers which would ease the burdens of regulation without the risk of substantial impact on consumer prices would be in the public interest. But it also determined (*Ibid.*) an outright exemption of small producers, assuming it was legally permissible, was neither "necessary or desirable."

In reaching this determination the Commission found a "basic consideration" to be that "the impact of small producer prices on consumers is by no means *de minimus* and is of great impact in some instances" (34 F.P.C. at 235). Though the small producers represented, the Commission, found only 15% of the aggregate interstate gas supply, the range insofar as individual pipelines was concerned was very great and "it is obvious they are a

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[2] The Commission in *Permian* had provided two cost questionnaires, the so-called Appendix B questionnaire, mandatory for large producers but voluntary for small ones, and a special Appendix C, less detailed than that required for the large producers, which the other small producers were asked to fill out. The limited number of actual responses to Appendix C showed average unit costs of approximately 2 cents per mcf higher than that shown by the larger producers. But the eighteen small producers who responded to the more detailed Appendix B showed lower costs on the average than the larger producers. And many of the smaller producers did not answer at all, or provided meaningless data. Thus the only conclusion the Examiner could make was that "on a per mcf basis, the small producers had relatively larger dry hole expenses, a smaller proportion of geological and geophysical expenses, and a smaller proportion of lease acquisition expenditures. On a unit basis smaller producers had a relatively larger DD&A expense than the larger producers" (34 F.P.C. at 361).

substantial factor in the cost of gas supply of millions of American consumers" (*Ibid.*). Also, the Commission found, the penetration of the rate ceilings which would result from an absolute exemption, even if on a small scale, could be "seriously disruptive of a pattern of uniform area rates" (*Ibid.*).

While making the area just and reasonable rates applicable to all producers, small and large alike, the Commission in *Permian* initiated action, consummated by Order 308 issued on November 5, 1965 to relieve small producers of virtually all of the administrative burdens and costs of both the rate and certificate provisions of the Natural Gas Act. *Rate and Certificate Filings by Small Independent Producers*, 34 F.P.C. 1202 (1965). This action took the form of the establishment of a program for the issuance of "Small Producer Certificates" available to any producer with jurisdictional sales of less than 10,000,000 mcf of gas per year, under which the producer would be able to make all of its existing sales and any new ones without seeking further authorization from the Commission as long as his total annual sales did not exceed the prescribed minimum, and any price authorized by his contract with the purchaser did not exceed the applicable just and reasonable ceilings for such gas in the particular area. While Order 308 was originally applicable only to the Permian Basin, the rule expressly contemplated that the coverage of the small producer certificates would be expanded to cover sales from the other production areas as just and reasonable prices were established for those areas. And in fact, as of the time of the instant proceeding, the small producer certificate program had already been expanded to cover the Hugoton-Anadarko, Southern Louisiana, Appalachian Basin and Illinois Basin areas, with the only remaining major areas being the Texas Gulf Coast, Other South-

west and Rocky Mountain areas in which rate proceedings were then still pending.

In addition, the Commission in its *Permian* decision gave small producers the option of being relieved from the requirements it imposed on large producers with respect to rate adjustments as a result of abnormal quality conditions (see 34 F.P.C. at 225).[3] This exception to the general area rate was justified by the Commission on the grounds of its *de minimus* effect on the overall gas costs and the fact that the costs of determining the necessary quality adjustments for the many small producers would be greater than the total amount of adjustment.

In its decision affirming the Commission's *Permian Basin* opinions the Supreme Court expressly affirmed the Commission's treatment of small producers. Specifically, it found that the Commission had a proper factual basis in the record for classifying small producers separately for purposes of its regulation and that the "carefully selected special arrangements for small producers" which the Commision had found "would not improperly increase consumer prices" were "fully consistent with the terms and purposes of [the Commission's] statutory responsibilities." *Permian Basin Area Rate Cases*, 390 U.S. 747, 787 (1968). Similar arrangements for ameliorating the Commission's administrative difficulties, the Court added, had been suggested by it in the *Hunt* case, *supra*. The Court's opinion, of course, does not hold that the Commission's power to classify small producers for special regulatory treatment authorized it to exempt them from all effective rate regulation; the Commission had rejected this approach and it was not advocated by any

[3] If, however, a small producer chose to avail itself of this option with respect to quality aspects which would have lowered the maximum rate they could charge for their gas, they were not permitted to take advantage of other quality provisions, such as higher than standard BTU content, which served to raise the maximum price.

party in the Supreme Court review of the Commission's decision.

The Proceedings Before the Commission

The present proceeding was instituted by a Notice of Proposed Rule Making (App. 1-13) issued by the Commission in Docket No. R-393 on July 23, 1970. In this Notice the Commission proposed simply to exempt small producers from all provisions of the Natural Gas Act and the Commission's regulations thereunder, except for the requirement of the existing small producer rule that they file an annual statement setting forth the volume of their jurisdictional sales (App. 2-3).[4]

In justification for its proposed action the Commission suggested that the relief previously granted under the existing Small Producers Certificate program "has been inadequate for small producers since they still bear many of the expenses and burdens of complying with regulatory requirements, particularly when they seek the same treatment accorded large producers. Such relief has also increased the difficulties inherent in processing small producer filings from an administrative viewpoint instead of decreasing these problems as was intended" (App. 2).

In addition to this alleged further relief from unspecified administrative burdens, the Commission added, without further explanation, that exempting small producers from compliance with the Natural Gas Act should encourage them to increase their exploratory efforts. At the same time, however, the Commission stated that the impact of the proposed exemption on consumers should be "minimal" since small producers account for a relatively small share of the gas produced nationally and "as

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[4] The only exceptions were with respect to "percentage sales" by small producers to other producers (under which they contract to secure a fixed percentage of the large producer's resale price) and sales to interstate pipelines by their affiliates (App. 1).

a practical matter" are not normally in a position to obtain more for their gas than the large producers whose sales are subject to the just and reasonable area rate ceilings (App. 2).

No attempt was made in the Notice at a legal justification for the Commission's action, other than a general reference to Justice Clark's suggestion in the *Hunt* case, *supra*, that the Commission consider the availability of exemption procedures.

Following the issuance of the Notice a large number of comments were filed, many of which opposed the exemption proposal or recommended substantial modification thereof. An informal conference between the members of the Commission staff and all interested parties was held on December 8, 1970, in which many of the objections expressed in the written comments were further detailed (App. 97-134).

On March 18, 1971, the Commission issued its Order 428 in the proceeding (App. 135-154). While this order was entitled as an "Order Establishing Blanket Certificate Procedure for Small Producer Sales and Providing Relief from Detailed Filing Requirements" it did nothing significant in either respect which had not been accomplished by the earlier Small Producer Certificate procedure established by Order 308 over five years earlier. But the new Order, while no longer purporting to exempt small producers from all rate regulation under the Natural Gas Act, in effect achieved this objective. It did so by relieving the small producer of all necessity for complying with the just and reasonable area rate ceilings which had been adopted for the various production areas or any other maximum price limitations.

This did "not constitute deregulation of sales by small producers" the Commission stated (App. 138) since it would "continue to regulate such sales at the pipeline

[and large producer-purchaser] level by reviewing the purchased gas costs of each pipeline with respect to small producer sales." But the "consumer protection" to be afforded by such review was promptly vitiated by the assurances the Commission gave to the pipeline and large producers that they would be permitted to pass on to their customers all increased costs resulting from any rates they might pay small producers for their gas as long as the rate was not "unreasonably high considering appropriate comparisons with *highest contract* prices for sales by large producers or the prevailing market price for *intrastate* sales in the same production area" (App. 140, 142; emphasis added).

The Commission did, however, limit its deregulation proposal in three respects. First of all, it stated that the abandonment provisions of Section 7(b) of the Act would continue to apply to small producer sales authorized by the blanket certificates (App. 140-141). The Order also provided that the exemption from the area price limitations would not apply to sales by small producers through the purchase of developed reserves in place from a large producer (App. 138). And finally, the Commission continued in effect for small producers the proscription against any *indefinite* price escalation clauses in gas sales contracts of the "favored nation" or "spiral escalation" type which would have the effect of increasing prices above the area just and reasonable ceiling.[5] Such clauses which would increase a small producer's contract price above the just and reasonable area level, the Commission concluded "would clearly be contrary to the public interest" since they would have an "adverse impact on consumers" (App. 138). Why *fixed* escalation clauses in

[5] These clauses had previously been proscribed for all new producer contracts after April 2, 1962, see *F.P.C.* v. *Texaco, Inc.*, 377 U.S. 33 (1964), and made ineffective above the just and reasonable ceiling in all other contracts in the Commission's *Permian* Opinion, *supra*, 34 F.P.C. at 239.

small producer contracts permitting increases above just and reasonable limits would not have a similar impact was not explained.

The Commission's justification for its action is sparse, and limited to summary statements of objective. Since the Commission as indicated above, purported not to be "deregulating" small producer sales, it confines its legal analysis of its action to a bare denial of the claim that the provisions of Sections 4, 5 and 7 of the Act are "mandatory and leave no room for administrative judgment and discretion", and a reference to the Supreme Court's language in the *Permian Basin Area Rate Cases*, noted above, relating to the Commission's classification powers under Section 16 of the Act (App. 146).

On the merits, the Commission no longer concludes that the impact of its action is *de minimus*, since it finds its action will affect over 10% of the gas purchased by pipelines from producers and an unspecified additional amount of gas purchased by large producers for resale to pipelines (App. 137). But it repeats without elaboration, the statement from its Notice that its action will ease the administrative burdens on the small producers and in the Commission's processing of small producer filings (while ignoring the additional burden imposed on pipelines and large producers, as well as upon the Commission in regulating these entities) (*Ibid.*).

Nothing, whatsoever, is stated in the Commission's Order as to why the removal of all price ceilings from flowing gas already committed to the interstate market by the small producer will result in any public benefit. And there is no effort on the part of the Commission to evaluate whether the cost to the consumer of its actions is likely to be matched by equivalent benefits: the implicit assumption of the Commission is that the necessary additional cost to the consumer from its program, no

matter how great, is in the public interest, if it increases the possibility of some increases in gas dedications to the interstate market, no matter how small.

New York filed, on April 19, 1971, a petition for rehearing of Order No. 428 and requested a stay of the effect of the Commission's order until at least 30 days after Commission action on rehearing (App. 214-220). A number of other applications for rehearing were also filed. However, in Order No. 428-B, issued July 15, 1971, the Commission denied the applications for rehearing, and except for a few minor modifications, Order No. 428 remained intact.

The Court of Appeals Decision

Petitions for review of the Commission's Order were filed by New York and several large producer or pipeline groups. On December 12, 1972, the Court of Appeals for the District of Columbia Circuit (Judges Wilkey and Robinson, with Judge Fahy dissenting in part) reversed (Pet. App. 1a-22a). The Court did not dispute the Commission's right to classify small producers separately for rate making purposes, or to provide different or higher rates for such producers upon a record providing a factual predicate therefor. But it concluded that the Commission's rule, in freeing small producers from all direct price restrictions and tying the indirect regulation at the purchaser level to sales at prices above the *highest contract price* by a large producer or the prevailing market price in the area for the unregulated *intrastate* sales, had failed to meet the just and reasonable standards established by Section 4 of the Act for all sales in interstate commerce for resale. Judge Fahy was prepared to accept, on an experimental basis, the Commission's contention that it could and would regulate the rates of small producers at the pipeline level. He made clear, however, that, in his view, this would

only be lawful under the Act if the small producers' rates continued to be subject to refund (and presumably immediate reduction) if they were found to be too high as a result of the review in the pipeline or large producer proceedings (App. 11a). He, therefore, would have approved the Commission's order upon condition that it be modified to require such adjustments in small producer rates in the event of such a subsequent finding (*Ibid.*).

SUMMARY OF ARGUMENT

While the Federal Power Commission in the orders under review freed small producers—those with annual sales of less than 10,000,000 Mcf—from all price regulation under the Natural Gas Act, it does not claim to have done so pursuant to any statutory power to exempt any class of natural gas companies from the rate provisions of the Act. Instead, it purports to have substituted indirect regulation at the pipeline and large producer level when these purchasers of the small producers' gas seek to pass on the costs to their customers. The Court of Appeals determination that this scheme for indirect regulation was unlawful is clearly correct.

1. Contrary to the Commission's contention, advanced for the first time in its brief on the merits in this Court, the Commission's Orders do not provide for an independent determination at the pipeline level of whether the small producers' sales to the pipeline were just and reasonable. Instead, the Commisison made clear that it would not question any pipeline's purchase of gas from small producers as long as the rate for such gas was at or below the level of the *highest* contract rate of any large producer or the prevailing rate for sales in the unregulated intrastate market. This was a deliberate action since the Commission's basic objective was to permit small producers to change more than the prevailing maximum area or national just and reasonable rate, and

it believed it essential to advise the pipeline and large producer purchasers of the extent to which they could freely pay such out-of-line rates. Only if the rate exceeded these parameters does the Commission contemplate an examination of whether, on the basis of its consideration of all relevant factors, the rates nonetheless meet the standards of the Act.

2. The highest contract rate or prevailing intrastate sales price is not a proper standard for determining whether interstate sales of natural gas for resale meet the Act's just and reasonable standard. On the contrary the courts have repeatedly rejected less extreme examples of market price standards even when they have been sought to be applied in certificate proceedings to fix the initial "in-line price" prior to the establishment of just and reasonable rate levels. See *Atlantic Refining Company* v. *Public Service Commission*, 360 U.S. 378; *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U.S. 223; *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U.S. 9. They are *a fortiori* inapplicable in fixing the just and reasonable price itself. While the Commission is not bound to any one regulatory format for fixing just and reasonable rates and in appropriate circumstances may not have to rely entirely on a cost based approach, there is nothing in the record in this proceeding which could conceivably justify equating the just and reasonable price for small producer sales with the highest levels of the unregulated market place. There arguably might be justification for setting the just and reasonable rates for small producers at a higher level than that fixed for producers as a whole—though no attempt has been made by the Commission here to provide the factual predicate for such an effort. But the Commission's market standard is simply deregulation, a matter for legislative concern rather than administrative action under the existing Act.

3. Assuming that the Commission provided for comprehensive regulation of the rate levels of small producer sales in pipeline rate proceedings, no such indirect approach to the Commission's statutory responsibilities is permitted by the Act. On the contrary, in *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672, when this Court first held that producer sales were subject to the Act's requirements, it expressly concluded that Congress did not intend to restrict regulation of the rates of sales of gas in interstate commerce to those made by the interstate pipelines. The Commission's Order in expressly freeing small producers from any refund or rate reduction obligation if it finds their sales prices to be too high upon its review of pipeline costs, merely reverts to the situation *Phillips* held to be unlawful. Regulation through a determination of whether a pipeline's costs of doing business, including the costs of purchased gas, are reasonable in the sense of being prudent under the circumstances in which the company finds itself, is, as a matter of law, not the same as regulation to determine whether the sales price itself is just and reasonable. The standards therefore are thus necessarily different. Moreover, as a practical matter, it simply is not feasible for the Commission to determine *ab initio* the propriety of a large number of small producer sales in the course of a pipeline rate proceeding, even if that proceeding is limited to purchased gas costs.

4. The Commission's Orders are, if anything, less defensible with respect to the unlimited increases they authorize in the rates small producers may charge for gas flowing under existing sales. For, unlike the case with new sales, the Commission's Order makes clear that there will be no review of the increased costs resulting from freeing such sales from direct rate regulation in any pipeline or large producer rate cases. The matter is by no means *de minimus* since well over 10% of the gas

presently moving in interstate commerce is sold by small producers and many of their sales contracts provide for rates susbtantially in excess of the maximum just and reasonable area rates. Nor has the Commission ever attempted in its orders or brief to justify its action with respect to existing sales as a matter of law, fact or policy.

ARGUMENT

Introduction

While the basic objective of the Commission's proceeding continues to be the complete deregulation of small producers from the rate provisions of the Natural Gas Act, its actions to achieve this result are now camouflaged in terms of the indirect regulation of such sales at the purchaser level. The Natural Gas Act does not authorize any such effort to free one level of sales by natural gas companies in interstate commerce for resale from regulation and to impose the entire burden for protection of consumer interests upon the intermediate large producer or pipeline purchasers when they resell the gas. And the practical problems of determining whether the host of individual small producer sales to a large producer or pipeline, at prices in excess of the general area or nationwide just and reasonable maxima established for natural gas producers, meet the standards of the Act are so great as to in themselves invalidate the project.

As the Court below recognized, however, even assuming that some type of indirect regulation of small producer sales was permissible under the Act, the Commission's Orders and its rule adopted therein must be set aside. For in addition to freeing small producers from any refund or rate reduction obligation for all of their sales, they provide that the costs of new small producer sales to the pipelines or larger producers may be passed on to gas consumers whenever they are no higher than

the highest large producer contract price or the prevailing area rate in the unregulated intrastate market. There is no legal or factual predicate for equating the just and reasonable level for small producer sales with such wholly unregulated criteria. And the invalidity of the Commission's actions are, if anything, even more patent, with respect to the existing sales being made by small producers, which the Commission freed from all regulatory restraint without any pretense of indirect review thereof at the large producer or pipeline level.

I. The Commission's Plan for Indirect Regulation of Small Producer Rates is Based Upon a Market Standard for Judging the Propriety of Such Rates Which is Invalid Under the Natural Gas Act.

A. *The Commission's Rule and Orders Provide that Small Producer Sales Costs May Be Passed On To Consumers Whenever the Rates are Consistent with the Highest Contract Prices of Large Producers or the Prevailing Market Price of the Unregulated Intrastate Market.*

The Commission at no less than three places in Order No. 428 (App. 140, 142, 150) made clear that pipelines and large producers [6] will be entitled to pass on to their customers whatever price they have paid to small producers for gas under *new* [7] small producer sales as long as these rates:

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[6] In the case of large producers, the costs of gas purchased from small producers can only be assured of being passed on to pipeline purchasers if, in addition, "the price differential between the purchase and resale prices does not exceed the prevailing price differential in the area" (App. 140, 142). But the Commission made clear this price differential would permit the large producers "to maintain the contract price difference between their purchase and resale prices" (App. 140).

[7] In the case of increases authorized by Order No. 428 in the existing sales by small producers to pipelines to their contract maxima (except for indefinite escalations) the Commission made

"... are not unreasonably high, considering appropriate comparisons with highest contract prices for sales by large producers or the prevailing market price for intrastate sales in the same producing area."

It was on the invalidity of this standard under the Natural Gas Act that the Court below primarily grounded its decision reversing the Commission. In its brief in this Court, however, the Commission attempts to argue that the Court below erred in concluding that "the Commission has clearly tied its determination to factors which it does not regulate or which derive solely from market forces" (Pet. App. 12a). The Commission's Order, it suggests (Br. 15-20), provides instead for consideration of "all relevant factors" pertaining to whether a particular small producer rate is "unreasonably high", of which the "two stated factors are only some of those which will be considered." If this were the true situation, the Commission's Order would still be subject to extremely serious questions discussed in Part II of this brief. But the fact of the matter is that the court below correctly construed the Commission's Order. Specifically, while the Commission indicated it was prepared to consider other factors in justification of a pipeline or large producer passing on costs from small producers where the contract price is *in excess* of the "highest contract price prevailing intrastate market price" standard, it repeatedly advised all parties that, where the small producer rate meets this standard, no further investigation will be made and the sale price will not be considered to be "unreasonably high".

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clear on rehearing that "there is no reduction or refund obligation with respect to increased small producer contracts" (App. 146, n. 5). In other words, there is not even to be any indirect regulation with respect to these sales, which in 1971 amounted to over 1,621,000,000 Mcf. See the more detailed discussion at pp. 42-46, *infra*.

The Commission's determination to give advance approval to the pipelines and large producers tracking in their rates small producer sales meeting this highest contract price/prevailing intrastate market price standard was a deliberate one, which it felt to be essential to its basic plan. On the one hand the primary purpose of the rule was to permit small producers to charge and collect rates which were *higher* than the prevailing just and reasonable area (or nationwide) norms without the necessity of filing individual requests for exceptions therefrom;[8] otherwise the pre-existing provisions of Section 157.40 of its Rules for small producer certificates, authorizing sales without further filings up to the area rates (see Order 308, *supra*, 34 F.P.C. 1202) would have been adequate. At the same time the Commission recognized that if it was to attempt to control the extent of those rate increases through its regulation of the purchasers it would at least be necessary to give them—the pipelines and large producers—some firm guidelines as to the degree to which they could deviate from the established just and reasonable norms with impunity. And, as the Commission also made clear (App. 143) it assumed that large producers and pipelines in their own best interests would

[8] At the time of the adoption of Order No. 428, requests for individual waivers of the area rates upon a showing of good cause were the vehicle for such requests. See, *e.g.*, *Permian Basin Area Rate Proceeding*, 34 F.P.C. 159 (1965), affirmed on this point, *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 771-773. Since that date the Commission has established a so-called "optional procedure" under which producers can seek certificates at rates in excess of the area just and reasonable maxima in individual certificate proceedings in which the Commission will, it states, determine whether the requested rate for the particular sale has been shown to meet both the just and reasonable standards of Sections 4 and 5 of the Act and the public convenience and necessity standard of Section 7. See *Optional Procedure for Certificating Sales of Natural Gas in Interstate Commerce*, 48 F.P.C. 218; Section 2.75 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 2.75. The validity *vel non* of this rule is pending on review in *Moss* v. *Federal Power Commission* (C.A.D.C., No. 72-1837).

normally keep within these market price parameters in contracting with small producers and thus to this extent, at least, protect consumers from prices in excess thereof.

The Commission's intent is made clear in Order No. 428-B where it said (App. 246):

> ". . . The Commission in the July 23 notice proposed to allow pipeline purchasers to file tracking increases of rate increases resulting from the issuance of blanket certificates, but that the collection of these tracking increases was to be subject to reduction and refund. In response to Consolidated's claim that the collection should not be so conditioned, the Commission in Order No. 428 modified the original proposal so as to limit the reduction and refund obligation of tracking increases to those *which reflect small producer prices for new sales above the standard set forth therein.* The standard also provides pipelines with a more concrete guide for the future actions than would exist in the absence thereof. *Simply put, the Commission wanted the pipelines to know in advance the boundaries within which they could freely contract with small producers*" (Emphasis added, footnote eliminated).[9]

The Commission's present about face, while understandable in view of the impossibility of justifying its contract price-intrastate market price standard, cannot be justified by the language of the Commission Order on which it relies. Thus, there is no qualification, whatsoever, about the circumstances under which large producers rate increase filings will be acepted without challenge "to per-

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[9] At page 24 of its brief in the Court below, the Commission fully recognized the true import of its Order, stating in response to pipeline contentions that the standard was too vague, that "the sole reason for setting forth the standard was to enable the pipelines to know in advance, with a greater degree of certainty, the boundaries within which they might contract freely with small producers, and thereafter include the costs relating thereto in their cost of service."

mit them to maintain the contract price differential between their purchase and resale prices" resulting from exempting small producers from all price contracts (App. 140). These filings, the Commission stated:

> ". . . shall be accepted, without refund obligation, as long as the price differential is consistent with prevailing price differentials in the area and as long as the small producer prices for new gas are not unreasonably high, considering appropriate comparisons with highest contract prices [for sales][10] by large producers or the prevailing market price for intrastate sales in the same producing area (*Ibid.*).

And this formulation of the standard was adopted, virtually without change [11] as Section 157.40(f) of the Commission's Regulations Under the Natural Gas Act, 18 C.F.R. § 157.40(f).

The discussion in Order No. 428 with respect to the circumstances under which pipelines may pass on the prices they pay small producers (App. 142-143) is somewhat lengthier but no less clear on the critical point that no question will be raised if the price is at or below *either* the highest large producer contract price *or* the prevailing intrastate market price in the area. The discussion is in response to a pipeline contention that their tracking rate increases should not be subject to any refund or reduction in view of the fact that the small producers are being freed therefrom. The Commission rejects this contention with respect to *new* small producer sales, "but only as to that part of the rate which is unreasonably high considering," etc. It then goes on to state that "tracking increases to the extent that they reflect small

[10] The bracketed words appear in Order No. 428, but were inadvertently left out in the Appendix.

[11] In the rule, the words "without refund obligation" are omitted, and the word "if" substituted in both places for the words "as long as".

producer prices for new sales above the standard set forth above may be suspended" and collected subject to reduction and refund (App. 142). It is in this context of a suspension of tracking filings seeking to pass on above standard rates that the Commission states it will consider "all relevant factors". And if there was any doubt left that this was its intent, the Commission follows it up with the statement that "in this manner *the market mechanism* in the light of regulation of pipeline rates will be protective of consumer interests" (App. 143).[12]

In short, the Court below was quite correct when it concluded that the Commission's indirect regulation of small producer rates was to be based upon a standard which would test the validity of the rates by their consistency with either of two levels—the highest large producer *contract* rates or the prevailing *intrastate market* price—neither of which was a regulated rate nor had any necessary relationship to a rate's conformity to the just and reasonable standard of Sections 4 and 5 of the Natural Gas Act.

B. *The Standard Adopted by the Commission for the Indirect Regulation of Small Producer Rates Is Inconsistent With the Natural Gas Act.*

Since the Commission now purports to deny that it has adopted an unregulated market price standard for determining, albeit indirectly, whether small producer rates are just and reasonable, its brief does not directly attack the court of appeals' rejection of this standard. Nor does it attempt to meet the promise of its Petition for a Writ of Certiorari (pp. 12-13) of demonstrating the

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[12] This language is followed by a paragraph reiterating that "if the resales by large producers to pipelines reflect new small producer sales at *prices in excess of the previously discussed standard*, the large producers' rates will be subject to suspension and refund" (App. 143).

validity under the Natural Gas Act of a Commission determination that "reliance on the market mechanism would encourage the highly competitive small producers to explore for new supplies of natural gas and would result in just and reasonable rates in the best interests of consumers". The Commission's failure in this respect would constitute a confession of error in the light of the showing above that the market standard is indeed the one prescribed by Order No. 428. It can, therefore, be confidently expected that the Commission will attempt to regroup and support the market standard in its Reply Brief. Its implicit recognition of the indefensible nature of its true position was, however, quite sound.

At the outset it should be recognized that the Commission's standard for determining whether small producer rates will be subject to challenge uses as its test contract price levels which are not only not subject to any regulatory limitation but certain to be substantially above whatever just and reasonable norm the Commission may have established. As the Commission's brief admits, (p. 16 n.10) large producer contract prices will "frequently" tend to be in excess of the area just and reasonable maximum, in the hope that the ceilings will be lifted by subsequent Commission actions, or deregulation legislation may be adopted. There is little if any data as to the extent that the "highest" of such rates will exceed the area limits, but evidence introduced by the Commission staff in a recent case indicated that in one period between November 1971 and January 1973 there were a number of sales made from the Southern Louisiana area at the area rate of 26 cents per Mcf which carried an initial contract price of as much as 45 cents per Mcf.[13] And

[13] See *Belco Petroleum Corp.*, —— F.P.C. ——, Docket No. CI73-293, Opinion No. 659, issued May 30, 1973. (Exhibit Nos. 10 and 27, which contain this data are not referred to in the Commission's Opinion).

recent contract prices for short term sales of gas in interstate commerce have ranged up to as high as 52-54 cents per Mcf,[14] though no area rate, including those established in 1973, is in excess of 35 cents per Mcf.[15] As for intrastate prices, there is no definition of "prevailing rate" which permits one to know whether the Commission is thinking in terms of a weighted average (for which there, to the best of our knowledge, is no existing data base) or the highest rate for substantial volumes of gas. But, recent Commission decisions have referred to individual sales at prices as high as 60 cents per Mcf.[16]

This is not the first time that the Commission has sought to utilize a market standard for evaluating the acceptability of producer rates under the Natural Gas Act. It attempted to do so in the late 1950's as the test for determining under the public convenience and necessity standard of Section 7(e) of the Act, whether producer sales should be certificated *pending* its determination of the just and reasonable rates for such sales. Such efforts were without exception rejected by the Courts, which held that not only must the Commission "hold the line" on producer prices pending determination of the just and reasonable rate levels, but could not certificate producer sales on the basis that they were no higher than others in the area which had not been certificated by the Federal Power Commission, or which, though certificated, were "suspect" in that they were in process of

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[14] See *Cities Service Oil Company*, Docket No. CI74-49, Initial Decision issued January 4, 1974.

[15] This rate was established on August 7, 1973 for new gas from the Permian Basin in the second round area rate proceeding for that production area. *Area Rate Proceeding (Permian Basin Area II)*, —— F.P.C. ——, Opinion No. 662.

[16] See *Atlantic Richfield Co.*, Docket No. CI73-691, Order of October 10, 1973 (unreported), issuing limited term certificates. Substantially higher intrastate prices have been reported in the trade press and cited in pleadings in pending Commission cases.

being reviewed or otherwise did not support the higher new price level. *Atlantic Refining Company* v. *Public Service Commission (CATCO)*, 360 U.S. 378 (1959); *Public Service Commission* v. *Federal Power Commission*, 361 U.S. 195 (1959), reversing *United Gas Improvement Co.* v. *Federal Power Commission*, 269 F.2d 865 (C.A. 3, 1959). *United Gas Improvement Co.* v. *Federal Power Commission*, 283 F. 2d 817 (C.A. 9, 1960), *certiorari denied, sub. nom. Superior Oil Co.* v. *United Gas Improvement Co.*, 365 U.S. 879; *Public Service Commission* v. *Federal Power Commission*, 287 F. 2d 146 (C.A.D.C., 1960), *certiorari denied, sub. nom. Shell Oil Co.* v. *Public Service Commission*, 365 U.S. 192; see *United Gas Improvement Co.* v. *Callery Properties, Inc.*, 382 U. S. 223, 227-229 (1965); *Federal Power Commission* v. *Sunray DX Oil Co.*, 391 U. S. 9, 18-19, 33-34 (1968). As this Court held in *Sunray DX Oil, supra*, at 19:

> "The Commission and the courts generally excluded from consideration or gave diminished weight to those current prices which were 'suspect' because they were embodied in permanent certificates still subject to judicial review; because they were contained in temporary certificates issued on the *ex parte* representations of producers; or because they had been certificated in proceedings before this Court's *CATCO* decision or in proceedings from which representatives of East Coast consumers and distributors . . . had been erroneously excluded . . . .

And earlier in *Callery, supra*, at 227, this Court had noted that:

> "Consumer protection is afforded by keeping the 'in-line' price at the level where substantial amounts of gas have been certificated to enter the market under other contemporaneous certificates, no longer subject to judicial review or in any way 'suspect.'"

The refusal to rely on suspect or out-of-line certificated rates, to say nothing of the highest contract rates or unregulated intrastate sales, in fixing the initial price to set the refund floor prior to determination of a just and reasonable rate, reflected this Court's view in *Federal Power Commission* v. *Sunray DX Oil Co.*, *supra*, 391 U.S. at 25-26, that:

> ". . . a belief that current contract prices in an area approximate closely the 'true' market price—the just and reasonable rate . . . would contradict the basic assumption that has caused natural gas production to be subjected to regulation and which must have underlain this Court's *CATCO* decision—namely, that the purchasing pipeline, whose cost of purchase is a current operating expense which the pipeline is entitled to pass on to its customers as part of its rates, lacks sufficient incentive to bargain prices down."

All of the above is a *fortiori* applicable to demonstrate the invalidity of establishing the highest contract rate level or the prevailing level of the unregulated intrastate market as the touchstone of what is "just and reasonable". As Judge Tuttle, speaking for the Court in *United Gas Improvement Co.* v. *Federal Power Commission*, 290 F. 2d 133, 135 (C.A. 5, 1961) *certiorari denied sub. nom.*, *Sun Oil Co.* v. *United Gas Improvement Co.*, 368 U.S. 823, stated:

> ". . . a price paid for gas as the result of arm's length bargaining with the producer is not, merely because bargained for in a highly competitive market, 'just and reasonable' within the intendment of the Natural Gas Act. . . . This is so because the only justification for giving the Commission the duty to regulate prices was the determination by Congress that the producers have a supply that is so restricted in relation to demand that they have the economic power to bargain for prices that will be injurious to the public. . . ."

This Court need not consider to what extent just and reasonable producer rates must be cost based, and to what extent the Commission may also consider non-cost factors. The Commission has always given some consideration to market prices (see *Permian Basin Area Rate Cases*, 390 U.S. 747, 795), and the lower courts have upheld challenges to the consideration of non-cost factors in addition to costs, as long as they are "clearly labeled as such and their basis explained" (*Austral Oil Co.* v. *Federal Power Commission*, 428 F. 2d 407, 441 (C.A. 5, 1970), certiorari denied, 400 U.S. 950). But no reviewing court has deviated from the position first enunciated in *City of Detroit* v. *Federal Power Commission*, 230 F. 2d 810, 818, (C.A.D.C., 1955), certiorari denied, 352 U.S. 829, in rejecting the last Commission effort to reply solely on field prices as the test of what is just and reasonable,[17] that costs must be utilized as the "point of departure", with such non-cost adjustments as may be added justified on the basis of "evidence and findings" showing that "the increase in rates thus caused is no more than is reasonably necessary for the purposes advanced for any increase."

On the contrary, while they are in conflict as to the extent to which the Commission may utilize non-cost considerations in fixing just and reasonable area rates for producer sales, both the Fifth Circuit and the District of Columbia Circuit have recently rejected producer arguments that their rates should have been fixed on market standards. See *Shell Oil Company* v. *Federal Power Commission (Other Southwest Area Rate Case)*, —— F. 2d

[17] The Commission in *City of Detroit* had not gone nearly as far as it seeks to go here. The "fair field price" standard, which the Court rejected, was defined as the "weighted average arm's length payments for identical natural in the fields . . . where it is produced," and was substantially below the current range of field prices. See also *Panhandle Eastern Pipe Line Co.*, 13 F.P.G. 53, 63 (1954).

——, (C.A. 5, Case Nos. 72-1114, *et al.*, decided June 8, 1973) petition for writ of certiorari pending, Case No. 73-438; *Texas Gulf Coast Area Natural Gas Rate Cases*, —— F.2d ——, (C.A.D.C., Case No. 71-1828, decided August 24, 1973) petitions for writ of certiorari pending, Case Nos. 73-966 *et al.*

As Judge Leventhal, speaking for the Court stated in the *Texas Gulf Coast Area Natural Gas Rate Cases, supra*, Sl. Op. at 25-26:

> "Another option does remain—that of setting the price of natural gas at the market price, or of allowing the market price to govern the 'just and reasonable price' of natural gas. A variant of this contention is the submission by the producers that in time of supply shortage, regulation for an area that serves not only an interstate market but also an (unregulated) intrastate market must set the regulated prices as high as the unregulated in order to prevent diversion to the intrastate market. However, so long as the legislature has assigned the agency the function of regulation of rates, it cannot legitimately execute that function in a fashion which, in fact, is tantamount to total deregualtion or nonregulation. Congress did not provide for agency action and court review as a charade" (Footnote eliminated).

Is it true that this Court, in its decision in the *Permian Basin Area Rate Cases, supra*, 390 U.S. at 795, in rejecting objections to the Commission's findings there that market mechanism was an inadequate surrogate for the just and reasonable standard mandated by the Act, stated it was not holding field prices to be "irrelevant" to the Commission's determination and that "the records in subsequent area proceedings may more clearly establish that the market mechanism will adequately protect consumer interests". But assuming, as the Court did not hold, that in such a case a just and reasonable standard based

solely on the *highest* contract rate or the unregulated intrastate market would be justified, that clearly is not the present situation. There was no study of the adequacy of the market to protect consumers in the Commission's proceeding leading to Order No. 428, and no findings to this effect, based on any factual predicate express or implied is contained in the Commission orders.

On the contrary, in all of its area rate decisions both before and after its issuance of Order No. 428, the Commission has rejected producer claims that it should abandon its cost anchor since the operation of market forces would adequately protect consumers. See, *e.g.*, *Area Rate Proceeding (Permian Basin II)*, Docket No. AR70-1, Opinion No. 662, issued August 7, 1973, Sl. op. p. 4. It could hardly have reached any other conclusion under current conditions. For if the pipelines could not be depended upon to bargain to the extent necessary to provide a private substitute for Commission regulation in periods of relative abundance of gas (see, *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 793-794), clearly they cannot be expected to do so in a period of scarcity.[18]

We do not suggest that the just and reasonable area or nationwide rates for the gas of small producers is necessarily the same as that for producers as a whole. In an appropriate new proceeding data might be developed showing that average small producer costs were greater

[18] Without necessarily suggesting that available gas reserves are being withheld from the interstate market in the hope or expectation of legislative deregulation, it is to be noted that Commission data indicates that as of mid-1972 the four largest independent producers of natural gas between them controlled no less than 48.4% of the reported uncommitted reserves in the United States, exclding Alaska. See, *Statement of John N. Nassikas, Chairman, Federal Power Commission Before the Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee*, June 20, 1973, Table 7.

than those for the producers in general.[19] Or there might be some factual predicate for providing small producers with a discrete non-cost allowance in excess of the general producer just and reasonable maxima. But an inchote belief that small producers need higher prices to render optimum service to interstate consumers tied, without any demonstration of a proper correlation, to a standard based upon the highest level of contract prices or the prevailing rate in the unregulated intrastate market, is an abandonment of the Commission's responsibilities under the Natural Gas Act to "afford consumers a complete, permanent and effective bond of protection from excessive rates and charges" by insuring that they are no more than necesary to the "maintenance of adequate service in the public interest". See *Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 388 (1959).

II. The Natural Gas Act Does Not Authorize The Indirect Regulation of Small Producer Rates Through the Regulation of the Rates of the Pipelines and Large Producers to Whom they Sell.

Sections 4 and 5 of the Natural Gas Act (F.P.C. Br. 35-38) in unequivocal terms provides for the regulation of all of the jurisdictional rates of all natural gas companies to the end that the rates for each such sale must be just and reasonable. As Section 4(a) makes clear "any such rate or charge that is not just and reasonable is hereby declared to be unlawful." There is no exception to these requirements; unlike such regulatory statutes as the Federal Aviation Act (see 49 U.S.C. § 1386), and the Natural Labor Relations Act (see *Guss* v. *Utah Labor Relations Board*, 353 U.S. 1, 13-14 (1957)), the Federal Power Commission is afforded no general exemp-

[19] But see footnote 2, p. 6, *supra*.

tion authority.[30] Thus, as the Court below noted (Pet. App. 8a and n. 11), ever since this Court's decision in *Phillips Petroleum* v. *Wisconsin*, 347 U.S. 672, it has been recognized that the Commission had mandatory jurisdiction over the rates of all producer sales in interstate commerce for resale regardless of the size of the producer.

The court below, as we understand its opinion, believed that there were very serious legal questions as to whether the Commission could substitute indirect regulation of jurisdictional sales by natural gas companies for the direct regulation mandated by the Act as interpreted in the *Phillips* case, *supra*. (See Pet. App. 7a-11a). However, it believed it to be unnecessary to resolve this general question in view of the patently improper standard adopted by the Commission for such indirect regulation at the pipeline and large producer level. We agree that this Court is not required to explore the outer limits of Commission authority if it agrees with our arguments in Part I of this brief. But the Commission should be made aware that it cannot cure the errors of its Order merely by adopting the more general standard for indirect review of small producer rates which its brief in this Court purports to support. We have set forth below some of the reasons this is true, leaving

[30] The only provision in the Natural Gas Act authorizing the Commission to exempt natural gas companies from any of its mandatory requirements is found in Section 7(c) of the Act. This provision is limited to permitting the Commission to exempt "from the requirements of this section," such "temporary" acts or operations of natural gas companies "for which the issuance of a certificate will not be required in the public interest."

The issue of whether this provision authorizes the Commission to exempt *temporary* sales by producers from the rate provisions of the Act is pending before the Court of Appeals for the District of Columbia in *Consumers Federation of America, et al.* v. *Federal Power Commission*, Case Nos. 73-2009, *et al.* There, as here, it is contended by the Commission that consumers will be protected from overly high rates through the indirect regulation of the purchasing pipelines.

to the briefs to be filed by the representatives of the pipelines and large producers discussion of the problems more directly affecting their interests.

1. In its original notice of proposed rule making in this proceeding (App. 1-12), the Commission looked towards the frank exemption of small producers from all of the rate restrictions of the Act (App. 2). As its sole authority for such action, the Commission cited (*Ibid.*) the dictum by Justice Clark in *Federal Power Commission* v. *Hunt*, 376 U.S. 515, in which he reiterated a suggestion he had previously made in his dissent in *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294, 329-330, that the Commission might consider exempting producers from at least the certification provisions of the Natural Gas Act.[21] In Order No. 428, the Commission stated its disagreement with arguments that the provisions of Sections 4, 5, and 7 which speak in terms of requirements applicable to all sales in interstate commerce for resale "are mandatory or leave no room for administrative discretion." In addition to the Clark dictum in *Hunt*, *supra*, the Commission referred to this Court's holding in the *Permian Basin Area Rate Cases*, 390 U.S. 747, that Section 16 of the Act, authorizing the Commission to "classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons or matters", justified the special treatment of small pro-

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[21] Justice Clark's dissenting statement in *Wisconsin* v. *Federal Power Commission*, *supra*, was in context of his disagreement with the Court approved move towards determining producer rates on an area basis rather than producer-by-producer, and was in terms of a possible "temporary" exemption of small producers while the Commission fixed the rates of the larger producers. *Hunt* involved the propriety of conditions in temporary certificates issued to producers, precluding rate increase filings pending action to fix the initial rate in the permanent certificate proceeding. Justice Clark opined that the administrative delays resulting from dealing with producer certificate applications on an individual basis could be largely avoided if the Commission found itself in a position to exempt small producers from the necessity of filing such applications.

ducers provided in that area rate proceeding. But the Commission no longer asserts this separate treatment of small producers can extend to their exemption from the requirements of the Act. Instead it denies its action constitutes "deregulation", in view of its intent to regulate such sales indirectly by reviewing the purchased gas costs of each pipeline with respect to small producer sales, and the "other safeguards against unreasonably high small producer prices" allegedly provided in its Order (App. 138).

If it were legally and technically feasible to ensure through such indirect regulation that producer rates met the Act's just and reasonable standard it conceivably could be held that the Commission met its statutory responsibilities by the indirect path it has chosen, despite the seeming language to the contrary in Sections 4 and 5 of the Act. See *Permian Basin Area Rate Cases*, *supra*, 390 U.S. at 374, where the Court rejected a somewhat similar argument against group rate making based upon an overly literal reading of the language of Sections 4 and 5. But this is not what the Commission intended by its scheme for indirect regulation. As we demonstrated in Part I of this brief, the standard which the Commission has adopted for determining whether the pipelines and large producer purchasers of small producer gas are entitled to pass on the costs of such sales to their customers, constitutes a complete abandonment of any effort to keep small producer rates to a "just and reasonable level". It is noteworthy in this respect that the single reference in either Order No. 428 or 428-B to the just and reasonable rate standard prescribed by the Act for all jurisdictional sales, is where the Commission states that indefinite escalation clauses in small producer contracts will only be permitted to operate to the extent they permit increases to the "applicable area just and rasonable rate

ceiling" (App. 138). But even if the Commission had fixed upon the just and reasonable area rates—or some other valid test of a just and reasonable rate—as the touchstone against which the actions of the pipelines or large producers would be judged, its actions would still be invalid.

Contrary to its suggestion that it had adopted "an innovative method of indirect regulation" which is responsive to the "unique problems and public functions" of small producers (F.P.C. Br. 11, 13), all the Commission has done is to revert to the situation which prevailed with respect to all producers prior to this Court's *Phillips* decision, *supra*, where the only protection to the public from excess gas costs was through the regulation of the pipelines. It was argued at the time that this was all the Congress had intended, since the danger of producers being able to charge unreasonable prices to the pipelines had not been considered to be serious as of the date the Natural Gas Act was adopted, but such contentions were rejected by the Court. See, *e.g.*, 347 U.S. at 681-682. Now that these incipient fears have proven to be very real, the Commission has retreated for this large class of producers to the regulatory scheme proscribed almost twenty years previously.

Far from "regulating" the small producers rates at the pipeline or large producer level, the Commission has expressly provided that even if such sales are subsequently held to be above the prescribed standard, the particular sales will not be subject to refund, or even prospective reduction. As the Commission stated in Order No. 428, "we seek to assure the small producer that when he enters into a new contract for the interstate sale of gas, the provisions of his contract will not be subject to change." (App. 137) Any doubt on this question was removed in Order No. 428-B where the Commission rejected a pipeline proposal under which it would review

the small producer rates within a 60-day period, but the producer, if he did not wish to accept the Commission prescribed rate level, could terminate deliveries without refund obligation, stating (App. 249):

> "The proposal does not go far enough. We want to facilitate the entry of the small producer into the interstate market and to assure the small producer that *when he enters into a new contract, the provisions of this contract will not be subject to change.* This can best be accomplished within the framework of the procedure we have adopted in Order No. 428." (Emphasis added)

Consistent with this statement, Section 157.40(c) of the rule adopted by the Commission in Order No. 428, 18 C.F.R. § 157.40(c), provides simply that "small producers certificated hereunder shall be authorized to make small producer sales nationwide pursuant to existing and future contracts at the price specified in each such contract."

The Commission brief does not dispute the fact that no refunds will be ordered no matter what the result of the "indirect" review of the propriety of the small producer's rate level. It does not suggest that a reduction in an unreasonable small producer rate will result from the pipeline review thereof. (It could not do so since the small producer's rates will not be in issue in the pipeline rate case and the small producer will apparently not even be a necessary party to the proceeding.) But the Commission brief does suggest (at p. 15) that in such circumstances it "remains free to institute separate proceedings under Section 5(a) to reduce the rate prospectively." This may be the situation as a matter of law, since there is nothing in the Act to foreclose the Commission from exercising authority it has previously foresworn. But see *Service* v. *Dulles*, 354 U.S. 363. But any

such action is not part of the Commission's regulatory plan.

The Commission's statement (App. 145) that it intends to continue to review small producer contract prices to assure their reasonableness under the regulatory plan it had adopted and "in the event we determine that *this approach* is inimical to the interests of consumers, we shall take further action to protect the consumers" (emphasis added), does not suggest that the Commission contemplates action to reduce existing sales. It is, on the contrary, merely a promise to review the results of its new program to determine whether it should be modified in the future. And in any event, this Court's *CATCO* decision (*Atlantic Refining Co.* v. *Public Service Commission*, 360 U.S. 378, 389-391), long ago determined that the availability of future Section 5 proceedings cannot justify existing rates which fail to meet the standards of the Act.

Even Judge Fahy who thought that the Commission's Order could in other respects be accepted as a good faith effort to develop an experimental regulatory program for small producers within the mandate of the Act, recognized that the Order to be lawful would have to provide for refunds (and presumably immediate rate reductions) by small producers to the pipelines or other jurisdictional purchasers in situations where they have been found to have charged unreasonably high prices (Pet. App. 22a)—a standard which he, erroneously in our view, equated with a Commission effort to determine indirectly the just and reasonable rates for such sales (Pet. App. 21a). But as the Court majority below pointed out (Pet. App. 10a-11a, n. 17) this requirement, in addition to compounding the uncertainty for all parties, would defeat the basic purpose of the Order, which was to assure small producers of their contract rates—whatever their level.

The indirect regulation proposal is, however, subject to other serious and we believe inherently fatal legal and practical problems. For the standards for judging whether the costs at which a regulated utility purchases equipment or supplies are quite different from those under which a regulatory agency will determine whether a regulated seller's price is just and reasonable. See *Colorado Interstate Gas Co.* v. *Federal Power Commission*, 324 U.S. 581, 622-623 (dissenting opinion).

The Commission's brief (pp. 32-33) cites its statement in Order No. 428-B (App. 245) that ever since the adoption of the Act "pipelines as regulated utilities have been permitted to include in their cost of service only those operating expenses, including the cost of purchased gas, which are reasonable", and argues further that such a standard of reasonableness is not unconstitutionally vague. But this statement is only true in the context of the basic regulatory principle that a pipeline or other regulated entity can include as part of its cost of service (if it is fixed on a cost basis at all), all prudent operating expenses contracted for under arm's length conditions irrespective of whether the sales price would be "just and reasonable" for a regulated seller. "If properly incurred, [expenses] must be allowed as part of the composition of the rates. Otherwise, the so-called allowance of a return upon the investment, being an amount over and above expenses, would be a farce" *Mississippi River Fuel Corporation* v. *Federal Power Commission*, 163 F.2d 433 (C.A.D.C., 1947). Or as the Commission itself stated in *Texas Eastern Transmission Corp.*, 29 F.P.C. 249, 256 (1963), affirmed *sub. nom. United Gas Improvement Co.* v. *Continental Oil Co.*, 381 U.S. 392 (1969), in rejecting as inadequate the indirect control of producer costs through regulation of a pipeline:

> ". . . Control limited to approving the costs of the gas to the purchasing pipeline is, of course, not an

effective way to regulate producer prices because in the large a pipeline must be allowed to pass on its purchased gas costs to the ultimate consumer or it cannot continue to discharge its public service responsibilities."

Consequently, in the absence of a showing of collusion or gross neglect, expenses of gas pipelines, including purchased gas costs, will necessarily be accepted as "reasonable"[22] if they are not totally out of line with general market rates for the service or commodity, regardless of whether this cost could be characterized as just and reasonable on any regulated basis.

Even if these problems of inconsistent regulatory theory could be surmounted, the practical problems inherent in indirect regulation of a large number of individual small producer sales at the pipeline or large producer level are so immense as to render any agency claim that it could or would actually review their propriety on a case-by-case basis subject to the highest degree of skepticism. The Commission stresses in both its Notice (App. 2) and Order No. 428 (App. 137) that one of its major objectives is to relieve both small producers and *itself* of the administrative burdens of regulation. As we have indicated, *supra*, p. 7, under the program initiated by the Commission in the *Permian Basin* proceeding, 34 F.P.C. 159, 234-236, and effectuated by its Order No. 308, *supra*, 34 F.P.C. 1202, the administrative burdens on small

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[22] In an earlier case in which the issue was the determination of the atcual legitimate original costs of a regulated utility's hydro-electric project, the Commission had stated, in language which we believe is equally applicable to the issue of disallowing pipeline operating costs, that "a claimed cost may be so in excess of the cost of comparable construction or purchase that it raises a question of *collusion, fraud* or *gross neglect* which would cast on the licensee the burden of proving the circumstances which would justify the claimed cost, and in the absence of such proof the claim in excess of what is reasonable should be disallowed. *Pennsylvania Power & Light Company*, 3 F.P.C. 89, 119 (1942) (emphasis added).

producers willing to sell at prices up to the area just and reasonable rates had been all but eliminated.[23] But if the Commission actually attempts to determine whether each of the small producer sales which will have been made to particular pipelines were just and reasonable in the pipeline's rate case, we would be returned with a vengeance to the administrative morass which led to the adoption of area rates for producers in the first instance. See *Wisconsin* v. *Federal Power Commission*, 373 U.S. 294 (1962). This is particularly true if, as the Commission now suggests, it would consider all relevant factors in reaching its determination and not operate according to any fixed standard.

Pipeline rate cases are complex and time consuming even in the absence of issues as to whether a large number of individual gas purchases from small producers at prices in excess of the established area or nationwide just and reasonable norms are nonetheless just and reasonable because of special circumstances of such sales. Presumably the Commission now contemplates that such issues would not normally arise in proceedings on general pipeline rate increases but would be considered sep-

[23] Under Order 308, as modified from time to time, small producers could secure blanket certificates authorizing them to secure the area just and reasonable area rates to the extent their contracts permitted without any further actions on their part. Any remaining administrative burdens related (1) to their need to secure certificates in those areas in which no area just and reasonable rate had been fixed—a situation of minimal significance today, (2) the need to making filings if they wished to secure rates in excess of the general area rate, in view of the Commission option given them to seek special relief with respect to particular sales if they so desired, and (3) some temporary problems which existed when Commission area rate orders were stayed on review, to permit small producers to continue making sales at rates in excess of the area rate, *pendente lite*. The Commission has never discussed the burden issue in any detail, but presumably the main burden of which small producers are being relieved is of demonstrating that prices in excess of the general area just and reasonable rate are just and reasonable for them.

arately in proceedings on pipeline filings under the purchased gas adjustment clauses recently authorized by Section 154.38(d)(4) of the Commission's Regulations under the Natural Gas Act, 18 C.F.R. § 154.38(d)(4), and specifically made applicable to small producer rate filings under Order 428.[24] To the extent such segregation of issues relating to small producer sales is feasible it will ease the burden, but only marginally. Moreover, since the small producers' rates will not be directly in issue in the pipeline proceeding and the pipeline rather than the small producers will have the burden of justifying such rates, the small producers in many if not most cases will not even be a party to the proceeding. It seems clear that the Commission would not have provided for such indirect review unless it had been convinced that in most cases there would be no difficulty in the pipeline or large producer showing that the rate was no higher than the highest contract rate for a large producer or the prevailing intrastate market rate,[25] and intended to make or require no further inquiry. (See Part I, *supra*).

[24] While the language of the Commission's Rule on purchased gas adjustment clauses does not appear to contemplate challenge to the reasonableness of the increased cost as long as the calculation is accurate, the Commission in its recent Orders in Docket No. RM74-3, in which it purported to exempt from all direct Commission regulation producer sales of less than a 180 day duration to pipelines experiencing system gas shortages, stated it would review the rates involved in such exempt sales in pipeline rate proceedings, including those involving purchased gas adjustment clause increases, and permit the pipeline to pass them on to their customers only where such rates can be shown to be required by the "public interest". See *Policy with Respect to Establishment of Measures to be Taken for the Protection of Reliable and Adequate Service for 1973-1974 Winter Heating Season*, F.P.C. Docket No. RM74-3, Order No. 491-B, issued November 2, 1973, p. 13.

[25] But Orders No. 428 and 428-B gave no indication as to how the prevailing intrastate market rate is to be determined, or the source of data therefor. (The Commission staff in recent years has periodically published data giving the range of intrastate sales prices, which have varied widely in all periods.) Nor is there any

III. There Is No Basis For Freeing Flowing Gas Sales By Small Producers From All Price Regulation.

While the basic thrust of the Commission's rule is the need to stimulate additional new gas search efforts by small producers in an era of gas supply deficiency, its Order also frees from any direct price regulation all of existing producer sales of flowing gas (App. 137). Moreover, unlike the situation with new sales, the Commission did not provide for *any* indirect regulation of the flowing gas sales of the small producers. Instead the Commission makes clear that the large producers and pipelines could pass the additional costs of its deregulation of small producer flowing gas sales regardless of the level of the resulting rate (App. 140, 142-143, 246). The Commission's brief contains no factual legal or policy justification for its action with respect to flowing gas, a deficiency which repeats the silence on this matter in Commission Orders 428 and 428-B.[26]

This complete deregulation of all existing small producer sales cannot be defended as *de minimus*. While the Commission attempted to so suggest in its original Notice (App. 2), it admits in Order No. 428 that over ten percent of the sales to the pipelines by independent producers in 1969 were from small producers, with some pipelines purchasing much higher percentages of their total gas supply directly from small producers (App. 137). Moreover, the Commission agrees that this figure understates the problem since it does not include the substantial additional amount of gas sold by small producers to large producers and resold by them to the pipelines (*Id.* at n.

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indication whether the highest large producer contract rate is to be for a sale in the same production area, or to be for gas of similar quality, quantity or vintage.

[26] New York had expressly challenged the justification for any application of the rule to existing sales of small producers in its petition for rehearing (App. 217).

1). The extent of the ten percent of direct pipeline purchases from small producers is known; in 1971 it amounted to approximately 1,621,028,242 Mcf of gas.[27] The amount of sales by small producers to large producers which would be exempted by Order No. 428 is not given by the Commission and, to the best of our knowledge, the Commission has neither published nor maintains any data thereon.[28]

The extent of the immediate exposure of gas consumers from increases in the small producers' rates for flowing gas depends upon the extent to which their contract prices exceed the area rate norms for gas of that vintage. See *United Gas Pipe Line Company* v. *Mobile Gas Service Corp.*, 350 U.S. 332 (1956). Here again, there is nothing in the record, or in any official compilation of Commission statistics, which permits any exact quantification. But as the Commission brief admits (at p. 16, n. 10), "large producers frequently contract to sell their gas at rates that exceed the applicable area rates", and the Commission's opinions and orders in other proceedings indicate that this excess of contract rate over the just and reasonable area rate ranges in many cases from 5 to 10 cents per Mcf or more. There is some statistical data which indicates that the very small producers (those with sales of under 2,000,000 Mcf per annum) do not average

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[27] See, *Sales by Producers of Natural Gas to Interstate Pipeline Companies* 1971, F.P.C. Office of Accounting and Finance, 1972. Table D, p. XV shows that the total 1971 sales to interstate pipelines by producers with sales of less than 2,000,000 Mcf was 823,844 Mcf. The sales of the producers with sales between 2,000,000 Mcf and 10,000,000 Mcf were calculated by adding the figures therefor shown on Table 1 at pp. 3-6.

[28] The magnitude of this factor of the problem can, however, be indicated by the statement in the record (App. 113-114) that from 40-50 percent of the total jurisdictional sales of Phillips Petroleum Company represented purchases from other producers, most of whom would qualify as small producers. Phillips 1971 jurisdictional sales amounted to 724,194,133 Mcf. See, *Sales by Producers of Natural Gas to Interstate Pipeline Companies*, *supra*, Table 1, p. 1.

quite as much per Mcf for the gas they sell to the pipelines as the large producers;[29] from these data it can be presumed that the excess of contract rates over area rates on the part of the small producers will be somewhat less than for the largest producers. But even if we assume that the average spread between the contract and area rates of small producrs is only one per cent per Mcf at the present time, the annual cost to gas consumers will be approximately $16,210,282 from direct small producer sales to pipelines alone—to which must be added the indefinite additional amount from indirect sales through large producers. And, of course, when the initial sales contracts expire, the small producers will be able to file unilateral rate increases *at least* up to the levels of the highest large producer contract rates on the prevailing intrastate market price.

The usual Commission excuse for providing revenues to producers for flowing gas in excess of costs, including a fair rate of return, is that this will provide producers with needed capital to reinvest in the search for new sources of gas for the interstate market. This can be expected to be the *ex post facto* rationale for the Commission's deregulation here provided in its reply brief. The validity of the basic concept has recently been rejected by the Court of Appeals for the District of Columbia. See *Texas Gulf Coast Area Natural Gas Rate Cases, Case* Nos. 71-1828 et al., —— F. 2d ——, decided August 24, 1973, petitions for certiorari pending, Case Nos. 73-966 *et al.* But in any event, there were good reasons why the Commission did not so claim in its Orders under review. In the first place, the recent Commission area rate decisions already include allowances in the flowing gas rates of up to 3.5 cents per Mcf for such

[29] See *Sales by Producers of Natural Gas to Interstate Pipeline Companies*, 1971, *supra*, Table B, p. VIII.

purposes.[30] And the Commission has also provided that in addition to the area rates, producers including small producers, can secure advance payments, the amount of which it has never fixed or challenged, from the pipelines for exploration and development purposes.[31] There is no basis for concluding that these allowances, in addition to their regular revenues from flowing gas sales, plus such sums as they can otherwise raise, are inadequate to the small producers' needs, provided, of course, the new gas price incentives are adequate. On the other hand, it is clear that gas consumers will secure no benefit from the Commission's absolute deregulation of such producers' flowing gas sales in the large number of cases that the small producer is no longer actively engaged in gas production, or operates primarily onshore and will in any event sell any new gas to the intrastate market,[32] or for other reasons chooses to take the money and run.

In short, it is clear that with respect to the flowing gas sales of small producers, the Commission has abandoned all regulation, without citing any authority there-

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[30] See *Area Rate Proceeding (Permian Basin II), supra,* Sl. Op., p. 5.

[31] See *Accounting and Rate Treatment of Advance Payments Included in Account No. 166, Advance Payments For Gas Development and Production,* F.P.C. Order No. 465, —— F.P.C. ——, issued December 29, 1972; *Uniform System of Accounts Prescribed for Natural Gas Companies,* 18 C.F.R. Part 201, Account No. 166.

[32] Because of transportation advantages and the absence of alternate fuels, the intrastate market for gas had traditionally been willing and able to pay whatever is necessary above the regulated interstate rate to secure the gas it needs from onshore areas. Gas produced in the Federal domain in the Gulf of Mexico is subject to the plenary authority of the Federal Power Commission since it necessarily involves interstate sales and transportation. See, *United Gas Pipe Line Company,* 30 F.P.C. 560, 562, 564, 597-605, affirmed *Louisiana Public Service Commission* v. *Federal Power Commission,* 359 F.2d 525 (C.A. 5, 1966), certiorari denied, 385 U.S. 833. But the operations of small producers in those areas are quite restricted.

for, and has done so without attempting to provide factual or policy justification for its action. Even if Commission's actions with respect to new small produ sales were determined to be within its powers, its acti with respect to the existing flowing gas sales by sm producers must therefore be set aside.

CONCLUSION

For the reasons set forth above, the opinion below versing and remanding the orders of the Federal Pow Commission involved in this proceeding should be affirm

Respectfully submitted,

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January 11, 1974